BRIEF IN SUPPORT OF PETITION FOR WRITS OF CERTIORARI.

Opinions Below.

As these cases are the same in every material respect, involving the same question and identical facts, they were argued and decided together in the courts below. The opinion of the Circuit Court of Appeals is reported in 141 F. (2d) 208 (J 59; K 55).* The opinion of the Tax Court of the United States is reported in 1 T. C. 228 (J 19; K 15).

Jurisdiction.

The statutory provisions believed to sustain jurisdiction of this Court are Sec. 1141 of the Internal Revenue Code and Sec. 240(a) of the Judicial Code as amended (28 U. S. C. 347). The judgments of the Circuit Court of Appeals sought to be reviewed were entered March 10, 1944 (J 66; K 62).

Question Presented.

The question is the same in both cases. It is whether, after the sale by trustees, at a loss, of improved real estate previously acquired through foreclosure of a bond and mortgage owned by the trust, that portion of the net proceeds of the sale to which the petitioners, the income beneficiaries of the trust, became entitled under the applicable rule of law of the State of New York, was income, taxable to the petitioners under the provisions of the Revenue Act

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* "J" refers to the Johnston record and "K" to the Klages record; as all material facts and the opinions below are the same, actual reference is necessary to only one record.

of 1936 and of the Sixteenth Amendment to the Constitution of the United States.

The applicable rule of law referred to is set forth in the opinions of the Court of Appeals of New York in *Matter of Chapal*, 269 N. Y. 464, 199 N. E. 762; and *Matter of Otis*, 276 N. Y. 101, 11 N. E. (2) 556.

Statutes Involved.

The statutes involved are Sections 161, 162 and 22(a) and (b) of the Revenue Act of 1936 which, in so far as pertinent, are set forth in the petition at pages 2, 3, and 4.

Facts.

The facts, which are the same in both cases, are set forth under the heading "Statement" at page 4 of the petition and are not repeated here in the interest of brevity.

ARGUMENT.

I.

An important question of Federal law is presented.

The precise question here presented has not been decided heretofore by this Court nor by any other court except those below in these two cases.

If an individual had owned and foreclosed the bond and mortgage and thereafter sold the real estate taken in foreclosure at a loss, as did the trustees here, clearly no taxable income would have resulted. The novel effect of the Circuit Court's decision, therefore, is to create taxable income through division of the sale proceeds between bene-

ficiary and remainderman where, if the interests had been combined, there would have been no income.

The decision does violence to the entire scheme of taxation set forth in Sections 161 and 162 of the Revenue Act. These sections contemplate that before amounts shall be income to the beneficiaries they must first be trust income and deductible by the trust. Here, in fact, the trustees had no income and so no income could have been distributed to petitioners.

In addition to the New York rule and those in other states[1] applicable in so-called "salvage operations", there is the further rule, followed in New York and elsewhere,[2] requiring apportionment of the proceeds on a sale by a trustee of originally unproductive real estate, which it is submitted also is affected by the decision herein.

The abolition of the Chapal-Otis rule in 1940 (L. 1940, ch. 452; eff. Apr. 13, 1940) does not detract from the importance of the question as such abolition does not affect trust estates in existence and having mortgage investments on the date of the enactment of the statute.

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[1] *Hudson County National Bank* v. *Woodruff*, 122 N. J. Eq. 444, 194 Atl. 266 (1937); *Veazie* v. *Forsaith*, 76 Me. 172 (1884); *Springfield Safe Deposit & Trust Co.* v. *Wade*, 305 Mass. 36; 24 N. E. (2d) 764 (1940); *Nirdlinger's Estate* (No. 2) 327 Pa. 171, 193 Atl. 30 (1937); *Greene* v. *Greene*, 19 R. I. 619, 35 Atl. 1042 (1896); *Quinn* v. *First National Bank*, 168 Tenn. 30, 73 S. W. (2d) 692 (1934).

[2] *Scott on Trusts* (1939) Secs. 240, 241, Vol. 2; *Lawrence* v. *Littlefield*, 215 N. Y. 561, 109 N. E. 611; *Jordan* v. *Jordan*, 192 Mass. 337, 78 N. E. 459; *Martin* v. *Kimball*, 86 N. J. Eq. 10, aff'd, p. 432, 96 Atl. 565.

II.

The Circuit Court's decision probably conflicts with applicable decisions of this Court.

The petitioners contended below and contend here that these cases must be judged in the light of controlling federal law; that, so viewed, all that occurred was a sale by the trusts of real estate acquired in foreclosure, resulting in a loss to the trusts so that the proceeds were only trust principal (and not trust income), a part of which was then allocated to the petitioners under the Chapal-Otis rule; and that, being trust principal, it was not income to them taxable under Section 162(b) of the Revenue Act as currently distributable trust income.

The effect of the Chapal-Otis rule, it is contended, is to treat the situation as if the creator of the trusts had specifically directed the apportionment of the sale proceeds, the result being analogous to a bequest or gift in the form of an annuity created by will or trust which is payable out of principal if income is insufficient, that is, it is payable in any event, and so is expressly exempted from income tax under Section 22(b) (3). *Burnet* v. *Whitehouse*, 283 U. S. 148; 51 S. Ct. 374. *Helvering* v. *Butterworth*, 290 U. S. 365, 374; 54 S. Ct. 221.

If, however, the Circuit Court did regard the petitioners' share as being trust income, the concept of "income" inherent in its decision, it is submitted, is in conflict with the definition that income is "the gain derived from capital, from labor, or from both combined * * *," and that what is or is not "income" under the Sixteenth Amendment must be determined according to truth and substance without regard to form. *Eisner* v. *Macomber*, 252 U. S. 189, 206, 207; 40 S. Ct. 189.

Here, the trusts recovered, on the sale, less than their original investment in the bond and mortgage (J 25; K 21) and less than their "cost basis" of the real estate for tax purposes; no interest on the defaulted mortgage, computed either to the foreclosure sale in 1932 or, under the Chapal-Otis rule, to the subsequent sale in 1937, was ever, in fact, collected by them (J 27; K 23). In reality, the sale proceeds were not trust income in any form or to any extent and resort to fiction is necessary to find trust income.

If the sale proceeds were not trust income, it follows that they were entirely trust principal, and petitioners' share therein was a distribution of trust principal. In such case that share retained the same character, for tax purposes, in the hands of the petitioners that it possessed in the hands of the fiduciary.

In *Helvering* v. *Falk*, 291 U. S. 183; 54 S. Ct. 353, this Court, in holding a beneficiary entitled to a depletion deduction on mining royalties received from a trust, said that the depletion allowance was a return of capital assets which was left untaxed under the Act and which "remained so in the hands of the beneficiaries." In *Eisner* v. *Macomber*, *supra*, true stock dividends were held not to be "income." And so, under a Treasury ruling of long standing, they are not taxable income when distributed to a beneficiary under state law or pursuant to the trust instrument (I. T. 1622; C. B. II-1, 135).* The decision of the Circuit Court, it is submitted, cannot be reconciled with the foregoing principle and decision of this Court.

In determining what is or is not taxable income, federal law and decisions, and not local laws, are controlling.

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* Similarly: Exempt bond interest; Art. 22(b) (4)-5; Regs. 94; I. T. 2067, C. B. III-2, p. 78; distributable capital gains, I. T. 3495; C. B. 1941-2, p. 195.

Lyeth v. *Hoey*, 305 U. S. 188, 193; 59 S. Ct. 155; *Burnet* v. *Harmel*, 287 U. S. 103, 110; 53 S. Ct. 74.

The Chapal-Otis rule merely established the rights of interested parties in and to a particular item of trust principal; neither the rule itself, the equitable reasons underlying it, nor the fictions employed in its exposition can, or serve to, create taxable income, any more than if the trust instrument itself had, in the absence of the state rule, specifically provided for the same apportionment. The Circuit Court's opinion, it is submitted, indicates that the Court, in arriving at its conclusion, relied entirely on its construction of the peculiarities and special incidences of the local rule, contrary to the principle of the *Lyeth* and *Harmel* cases, *supra*.

III.

The Circuit Court's decision probably conflicts with applicable decisions of the local courts.

The nature of the rights acquired by the petitioners under the Chapal-Otis rule is set forth with particular clarity in *Martin's Estate*, 165 Misc. 597, where the question was as to the right of a trustee to extend and consolidate, without the consents of life tenants and remaindermen, certain purchase money mortgages which were (as in the cases at bar) a part of the proceeds of a sale of property acquired by a trust in foreclosure. In holding such consents unnecessary the court said (pp. 609-610):

> "The *res*, i.e., the salvage proceeds, is at all times owned wholly and exclusively by the fiduciary. There is no tangible property interest in the *res* as such inuring to the income beneficiary or to the remainderman. What each of these persons has is

> only the right (exercised in an accounting or other appropriate proceeding) to have the fiduciary properly allocate the money or property in his hands. That right in an appropriate case may be assignable, but it does not rise to the status of a title to the *res* or to any portion of it. That title is in the fiduciary with all the attendant rights of management."

The rights of the petitioners, therefore, with respect to the real estate itself or to the proceeds realized on its sale, were certainly not those of a lienor as the Circuit Court stated (J 65; K 61).

The Circuit Court apparently regarded the sale proceeds as representing *pro tanto* a recovery of interest, and so income, to which the petitioners were entitled. If that were so, then, under Section 15 of the Personal Property Law of New York, the petitioners' right to such "income" would not be assignable. Yet the New York courts have held that the right is assignable, thus negativing any contention that it was a right to trust income. *In re Renn's Will*, 42 N. Y. S. (2d) 400, 403; (Surrogates Court; not officially reported); *Martin's Estate, supra*, p. 609.

For the reasons set forth, it is respectfully prayed that this Court issue a writ of certiorari in each of the cases at bar.

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